# REPORT No. 6

## The Friedland Report: A Synthesis and Commentary

David W. Conklin, 1988

Public Sector Pensions Consultations

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# Report #6

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# Table of Contents

Part I: Overview . . . . . 1

Part 2: Analysis and Commentary by Chapter . . . . . 10

Public Sector Pensions Consultations

# THE FRIEDLAND REPORT: A SYNTHESIS AND COMMENTARY*

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## PART 1: OVERVIEW

The Friedland Report is written on the basis of Section 54 of the Pension Benefits Act, 1987 which requires that pensions be adjusted to provide inflation-related increases. The purpose of the Report is not to debate the appropriateness of Section 54, but rather to recommend how it should be implemented. Three volumes of research studies analyze the issues involved in implementation and investigate alternative options for implementation. Chapters 1-13 of the Report are based on these research studies, and each chapter presents the analysis and options related to a particular aspect of inflation protection. Chapter 14 and the Minority Statement present the opinions and recommendations of the Task Force.

Underlying Chapter 14 and the Minority Statement is the belief that the recommendations should focus on legally mandated minimum standards.

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* The interpretations and opinions are those of the author and should not be attributed to the Public Sector Pensions Consultations or any other group or individual.

A finding of the utmost importance is that the costs of inflation protection differ substantially among plans, and that for each plan, these costs differ substantially over time. Full inflation protection, incorporating 100% of the CPI increases, would impose very high costs on many plans. Full retroactivity would impose additional high costs on many plans. Furthermore, history shows that inflation rates have varied significantly over time, and that the rates of return to investment portfolios have also varied significantly over time. Quite apart from the high cost for many plans of full inflation protection with retroactivity, the likelihood of future variations in inflation rates and rates of return means that all plans are exposed to significant risk of variability in costs and funding. By focussing its recommendations on legally mandated minimum standards, the Task Force believes that the negative impacts on Ontario firms' competitive positions - and hence on employment and profitability - should be constrained to an acceptable level.

Yet, for some employers, full inflation protection with full retroactivity may not unduly harm the firm's competitive position. In the opinion of the Task Force, such employers should be encouraged to exceed the legally mandated minimum standards. In particular, the provision of retroactivity is highly desirable from the perspective of fairness, equity, and compassion - and so the area of retroactivity deserves special attention as the focus for incentives to exceed the legally mandated minimum standards. Nevertheless, it is recognized that retroactivity does entail the added problem that it overturns an

agreement previously accepted by those concerned. Retroactivity may be undesirable as a legal requirement from this perspective quite apart from costs. Linking retroactivity with existing surpluses is a way of dealing with this, since surpluses are also a development not foreseen in the original pension agreement.

It is from this perspective of constraints on costs and constraints on the risk of variability in costs and funding that one should consider the Task Force recommendations for only partial inflation protection, for caps on the annual adjustments, and for no obligatory retroactivity. The possibility that the needs of the elderly might decline in such a way as to justify only partial indexing was an hypothesis that was examined in depth but was rejected. The full indexation of OAS and CPP/QPP were seen as providing a substantial income support. Nevertheless, cost considerations were the only justification for less than full inflation protection in employment pension plans. Honest judgements may differ in regard to the ability of Ontario employers to afford these costs, and in regard to the impact of higher costs on employment, profitability, and even firm bankruptcies. Furthermore, the affordability and impacts may change over time. What society considers the appropriate minimum standards today may be replaced in the future. This possibility of increases in the minimum standards over time is not presented in the Report, but it does deserve serious consideration.

An alternative approach to constraints on costs and constraints on the risk of variability in costs and funding would be to impose higher

legal requirements (perhaps even full inflation protection with full retroactivity), and then to permit exemptions on a case by case basis. For example, any employer whose funding costs exceeded a certain percentage of payroll could apply for an exemption to the legal requirements, to the extent that costs would be constrained to the stipulated percentage of payroll. This alternative approach was rejected by the Task Force, but may deserve serious consideration, particularly if the minimum standards are raised sometime in the future.

The Report distinguishes sharply between defined benefit plans and other plans. Defined benefit plans promise a certainty in regard to the monetary or nominal value of the benefit, and this certainty may be both an advantage to the employee in providing some measure of security, but also a disadvantage in exposing the monetary benefit to the impact of inflation. A key issue here - and an issue perhaps not dealt with adequately in Mr. Coward's report - is the variation over time in inflation and inflationary expectations. A pension agreement established in the context of today's inflation and inflationary expectations may be abruptly altered by changes in tomorrow's inflation and inflationary expectations. These changes can alter the pension fund's nominal rate of return and its real rate of return. In defined benefit plans, these alterations may impact the plan's surplus or deficits in one direction, while they may impact the purchasing power of the employee's nominal pension in the other. Hence these unforeseen changes can cause a redistribution of wealth, with current pensioners being the losers, while employers and active workers may be the winners. This problem of

redistribution has been particularly acute in recent years. The purchasing power of a defined benefit pension has fallen by 75% over the past twenty years, while many plans have recently accumulated huge surpluses, and while many plans have used the unforeseen fund returns to improve the benefits promised to active workers.

On the other hand, plans with an "undefined benefit" (defined contribution or RRSPs) involve uncertainty as to the monetary or nominal value of the benefit, but also generally provide a benefit whose real purchasing power varies with inflation. There is no redistribution of wealth within the plan as a result of unforeseen changes. This basic difference motivates the Task Force to provide some recommendations that are directed specifically at defined benefit plans. In particular, the Task Force recommends that a plan must provide some retroactivity in inflation protection before the sponsor can withdraw any surplus.

The Task Force believes that the availability of indexed bonds would enable pension funds to reduce the impact of unforeseen changes in inflation and inflationary expectations. This would be particularly helpful with defined benefit plans, improving the accuracy of cost and benefit projections and thereby diminishing the probability of unforeseen surpluses or deficits. Consequently, the Task Force recommends that the Ontario government issue indexed bonds. A point not noted in the Report is that the real return on indexed bonds could vary over time. While such instruments currently yield a relatively high real rate of perhaps 4% annually, a lower real rate could develop as such instruments become

more popular. A fund administrator might then have to choose between a relatively low, but guaranteed real rate with index bonds, on the one hand, and the possibility of a higher real rate but more risk and uncertainty with a conventional portfolio on the other.

The importance of actuarial, accounting, and tax provisions permeates much of the analysis and recommendations. The pension funds and employee benefits are impacted at many points by a large number of regulations and conventions. For defined benefit plans, in particular, the choice of assumptions in estimating costs and benefits is a subject of great significance and great uncertainty. This perception does not receive the prominence it deserves in much pension literature. Mr. Coward's Report, for example, may be interpreted as a precise and permanent solution in a situation where no precise and permanent solution is possible. Relatively small differences in estimates of certain parameters can result in substantial differences in the calculation of costs and benefits. This sensitivity to the particular assumptions chosen -combined with the historical reality of significant variations over time in these parameters - means that a pension agreement created at one moment in time may turn out quite different from the expectations of all the parties involved. It should be noted, for example, that Professor Pesando's paper "Choosing the Real Interest Rate to Value Fully Indexed Pensions," bears upon several important calculations in addition to the calculation of the required contribution rates. The calculation of commuted values for purposes of the 50% employee contribution rule may be affected, as well as the calculation of commuted values for purposes

of portability.

Within defined benefit plans, a subject where the actuarial assumptions are particularly important is that of deferred pensions. The Task Force recommends that deferred pensions have the same legally mandated minimum standards as other pensions, both for the period of deferral and also for the period of benefit payments. However, the Pension Benefits Act, 1987 gives each terminating employee the right to withdraw the commuted value of the deferred pension. Here the choice of actuarial assumptions in calculating the commuted value of the indexed pension is particularly important, and a range of values could be justified. This adds considerable difficulty to the terminating employee's decision concerning whether to leave the deferred pension in the fund or whether to withdraw it.

Another central theme, articulated in Trossman's research study, Market Shifting of the Costs of Inflation Protection, is that a government decree of a particular cost-sharing formula may not be effective or even meaningful. In many employment situations, both employer and employee realize that hiring and remuneration decisions must be based on the total compensation package. An increase in pensions by way of indexation will be offset by a reduction in some other elements of the compensation package. Some recent union negotiations where automatic indexation has been achieved have explicitly acknowledged the acceptance of a lower wage increase than would otherwise be appropriate. Much of the pension literature erroneously views the nominal cost division

between employer and employees, and the contribution rates of each, as reflecting the actual cost division and actual contribution rates. In practice, the actual cost division will depend upon market shifting of these costs and the particular market circumstances for the hiring of labour and for the sale of the firm's products. Hence a useful focus for analysis is the actual market situation for each pension agreement, and the ultimate result when increased pension costs have been shifted, largely or entirely onto employees through lower wages than they would otherwise receive.

Although not articulated in the Report, this perspective suggests that government paternalism underlies much pension legislation. The objective is not only the redistribution from employers to employees, which may be uncertain because of the market shifting of costs in any case. Much legislation simply mandates certain attributes or characteristics in pension benefits which employers and employees have not always chosen. Indexation can be seen in this light. There are indications that employees often do not want indexation when they understand that it involves a cost for which they will have to pay. Offered an explicit choice, the expressed desire for indexation would often be replaced by the preference for a higher initial pension benefit, with a gradual decrease in purchasing power. Yet society as a whole may not wish to permit this free choice.

An important exception to the total compensation perspective occurs in regard to retroactivity. Pension indexation of previously accrued

benefits will not likely be seen in the wage negotiation process as a gain for current employees. Consequently, retroactivity generally involves a direct impact on the value of shareholder equities to a degree that prospective inflation protection does not. This aspect also warrants different legislated requirements for prospective and retroactive inflation protection.

The Report notes that "[i]n submissions to the Task Force, and in our public hearings, no issue aroused more heated discussion than the question of surplus ownership" (p. 253). The Pension Benefits Act, 1987 requires in Sections 79 and 80 that an employer wishing to remove surplus must obtain the prior consent of the Pension Commission of Ontario (PCO). The PCO must be satisfied that a surplus exists and that the plan documents entitle the employer to the surplus. If a plan is silent in regard to surplus ownership, then Subsection 80(2) deems the withdrawal of moneys accrued after 31/12/1986 to be prohibited. This provision does not deal with surpluses that arose prior to 31/12/1986. This issue remains controversial and subject to judicial interpretation.

Within the legal profession, there is no consensus on this question. Judicial decisions have been based on contradictory opinions. Some see pension funds as established on the basis of a specific contract. Their only purpose is to provide for the defined benefit in that context. Hence any surplus belongs to the employer. This contract perspective sees employees as entitled only to the contractually promised benefit. On the other hand, some see pension funds as a trust established for the

benefit of the employee. These are funds held in trust for the employee, and so the employer may not claim ownership of the fund or any surplus that has arisen in it. Within the research studies, Professors Ralph Scane and Donovan Waters hold the first view, while Professor Bernard Adell and Raymond Koskie hold the second view.

Finally, the issue of contribution holidays deserves comment. One might consider these to be the equivalent of surplus withdrawal, but the Report recommends that they be dealt with differently. While surplus withdrawal should depend upon provision of retroactive inflation protection, contribution holidays should not be constrained.

In a separate statement, Mr. Pilkey argues for obligatory retroactivity and a prohibition of surplus withdrawals, and contribution holidays.

## PART 2: ANALYSIS AND COMMENTARY BY CHAPTER

### Chapter 1: Introduction

Over the past twenty years, inflation rates have been high and volatile. The purchasing power of a defined benefit fell by 75% between 1965 and 1985. Meanwhile, life expectancy has risen, and so future pensioners will live longer and be subject longer to the cumulative effects of continuing inflation. Yet few private sector plans are automatically indexed.

At the same time, many defined benefit plans have gained large

surpluses. Concern has arisen among many interests over the control, ownership, and use of surpluses.

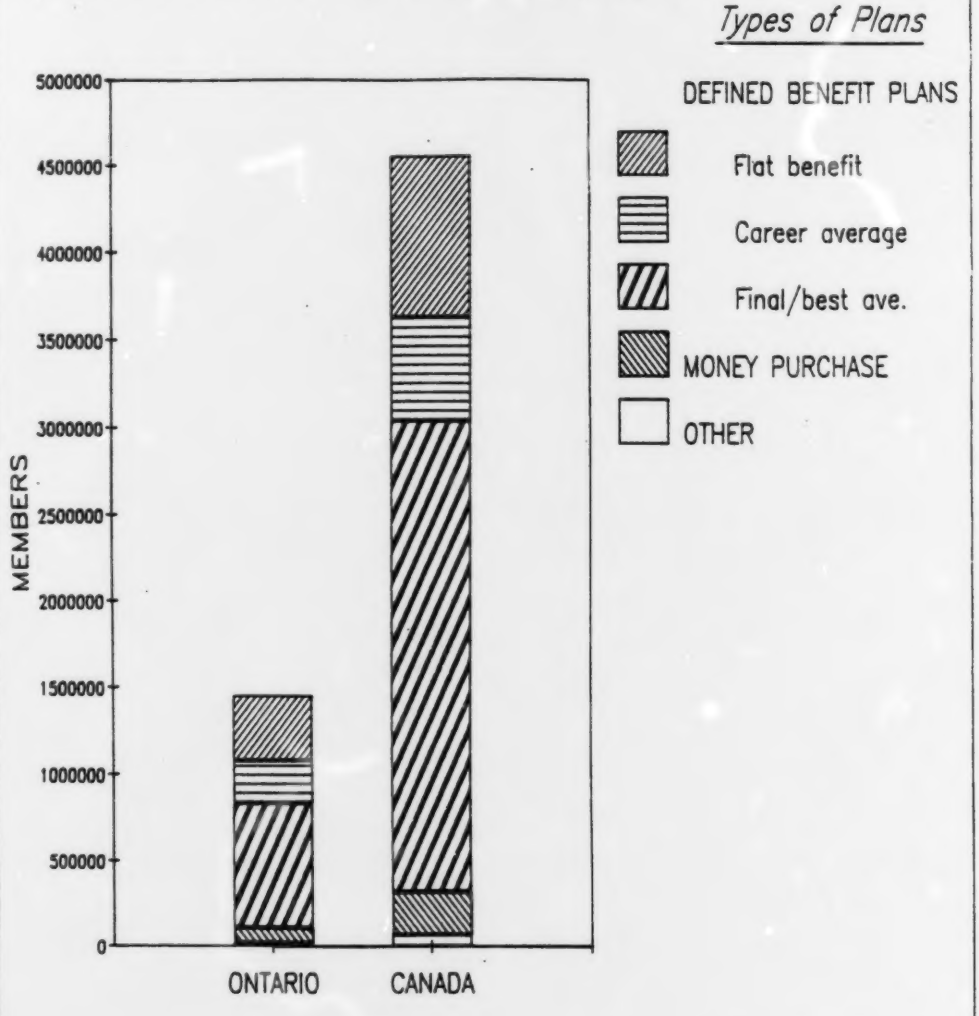
**Chapter 2: Coverage and Types of Plans**

Employment pension plans, RRSPs, and private savings form only one tier of the Canadian retirement income system. The other two tiers are the old age pension, and the CPP/QPP. Figure 2.2 indicates the number of members who belong to each type of pension plan, both in Ontario and in Canada as a whole. Approximately 93% of members belong to defined benefit plans. In recent years, there has been a switch away from career average plans, probably because these do not provide satisfactory pre-retirement inflation protection. Periodic negotiations can increase flat benefits as inflation occurs. Final earnings plans involve the automatic escalation of promised benefits prior to retirement, to the degree that wage increases keep pace with inflation.

Only about 6% of plan members belong to defined contribution plans. This may be because defined benefit plans offer some security in regard to the monetary or nominal value of the benefit. With a defined contribution plan, the total amount of funds available at retirement will depend on prices in the stock and bond markets at the time of retirement. All investment risk is placed on the employee, Furthermore, the size of annuity one can purchase will depend upon the level of interest rates at the time when one retires. Hence defined benefit plans offer some security that a defined contribution plan cannot offer.

**FIGURE 2.2**

## Membership of Employment Pension Plans in Ontario and Canada, 1984




SOURCE: Tables 2.9 and 2.10

However, once the defined benefit has been promised, any unforeseen change in rates of return to the fund can create a surplus or deficit. If both inflation and real rates rise, a surplus may develop at the same time that the purchasing power of the defined benefit is eroding. The surplus may be used to the advantage of the employer through surplus withdrawals or contribution holidays; or to the advantage of the active workers through plan improvements. Hence a basic redistribution of income can occur, with existing pensioners being the losers. The Task Force considers such a redistribution to be fundamentally inequitable.

Table 2.5 indicates the proportion of Canadian plans and the percentage of members having automatic inflation protection. In the private sector, only 6.3% of members have automatic inflation protection; in the public sector, 65.8% of members have automatic inflation protection. Table 2.10 indicates the numbers of Ontario members in each of 18 categories of plans.

**Chapter 3: Present Practices**

The first two tiers of the retirement income system are composed of government programs: old age security, supplemented by the Guaranteed Income Supplement (GIS), the spouse's allowance, and Ontario's Guaranteed Annual Income System (GAINS); and the CPP/QPP. The OAS and CPP have an automatic escalation formula, while the others have received regular ad hoc increases.

Figure 3.1 indicates, for Ontario plan members, the percentage of

## Table 2.5

## PROPORTION OF CANADIAN PLANS HAVING AUTOMATIC INFLATION PROTECTION

Automatic escalation of pension benefits in the public and private sectors, showing plans and members, 1984

| | Both Sectors | | | | Public Sector | | | | Private Sector | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Plans | | Members | | Plans | | Members | | Plans | | Members | |
| | No. | % | No. | % | No. | % | No. | % | No. | % | No. | % |
| Automatic indexing: | | | | | | | | | | | | |
| Full indexing with consumer price index | 249 | 1.4 | 189,526 | 4.2 | 29 | 3.6 | 180,841 | 8.9 | 220 | 1.3 | 8,685 | 0.3 |
| Partial indexing | 588 | 3.3 | 1,306,148 | 28.6 | 67 | 8.4 | 1,154,031 | 56.9 | 521 | 3.1 | 152,117 | 6.0 |
| TOTAL | 837 | 4.7 | 1,495,674 | 32.8 | 96 | 12.0 | 1,334,872 | 65.8 | 741 | 4.4 | 160,802 | 6.3 |
| No automatic indexing | 16,874 | 95.3 | 3,068,949 | 67.2 | 707 | 88.0 | 694,057 | 34.2 | 16,167 | 95.6 | 2,374,892 | 93.7 |
| GRAND TOTAL | 17,711 | 100.0 | 4,564,623 | 100.0 | 803 | 100.0 | 2,028,929 | 100.0 | 16,908 | 100.0 | 2,535,694 | 100.0 |

NOTE: Plans in which employers voluntarily grant 'ad hoc' benefit increases to compensate for inflation are considered not to have automatic indexing and are so classed in this table.

SOURCE: Statistics Canada, Pension Plans in Canada 1984, p. 52.

## Table 2.10

### DIFFERENT KINDS OF PLANS IN ONTARIO

Ontario pension plans and members by type of plan

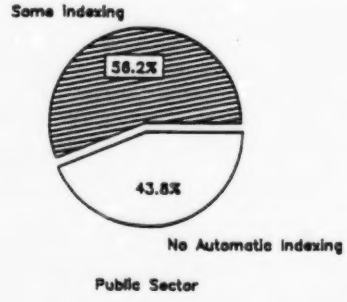
| | Number of plans | | | Ontario members | | |
|---|---|---|---|---|---|---|
| | 1970 | 1978 | 1984 | 1970 | 1978 | 1984 |
| 'Pure' Defined Benefit Plan Types | | | | | | |
| Private Sector: | | | | | | |
| Flat Benefit Non-Contributory | | | | | | |
| 1. Single-Employer | 347 | 615 | 700 | 174,633 | 231,360 | 234,036 |
| 2. Multi-Employer | 22 | 57 | 66 | 21,973 | 62,731 | 113,291 |
| Final or Best Average | | | | | | |
| 3. Contributory | 311 | 684 | 741 | 54,869 | 125,009 | 137,462 |
| 4. Non-contributory | 324 | 577 | 1,156 | 54,475 | 102,230 | 124,479 |
| Career Average | | | | | | |
| 5. Contributory | 2,357 | 2,154 | 1,565 | 183,011 | 169,460 | 154,803 |
| 6. Non-contributory | 254 | 364 | 423 | 47,883 | 67,439 | 74,265 |
| Public Sector, Contributory: | | | | | | |
| Final or best average | | | | | | |
| 7. Non-indexed | 19 | 22 | 26 | 220,485 | 214,150 | 249,900 |
| 8. Indexed | 0 | 3 | 4 | 0 | 215,956 | 212,095 |
| 9. 'Pure' Private Sector Money Purchase and Profit Sharing Plans | 4,256 | 3,461 | 3,749 | 58,719 | 102,576 | 88,115** |
| Miscellaneous Plan Types | | | | | | |
| 10. Composite | 205 | 169 | 134 | 15,623 | 12,841 | 17,688 |
| 11. Career Average, Public Sector | 33 | 23 | 16 | 86,194 | 20,830 | 15,020 |
| 12. Other Flat Benefit, $/Month/Year | 83 | 76 | 79 | 28,800 | 28,198 | 28,919 |
| 13. Other Flat Benefit, $/Month | 93 | 63 | 30 | 5,573 | 3,953 | 2,716 |
| 14. Level Percent of Earnings | 27 | 11 | 3 | 1,262 | 332 | 43 |
| 15. Public Sector, Non-Contributory, Final average or Average Best | • | • | • | • | • | • |
| 16. Other Unit Benefit, Private Sector | 28 | • | 4 | 53 | • | 8 |
| 17. Not Flat Benefit, Multi-Employer | • | • | • | • | • | • |
| 18. Not Elsewhere Classified | 124 | 91 | 52 | 13,468 | 5,227 | 4,812 |
| All Plans | 8,485 | 8,378 | 8,752 | 967,548 | 1,364,178 | 1,458,831 |

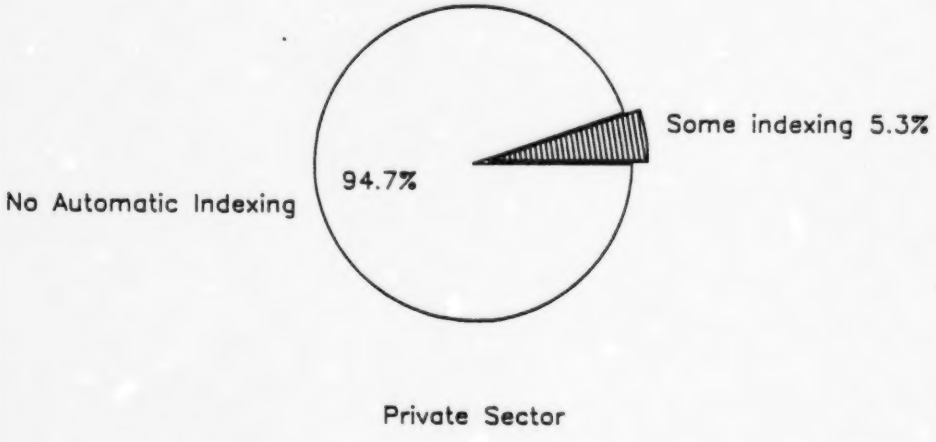
* Fewer than three pension plans

** About 90 per cent are money purchase plans.

SOURCE: Michael C. Wolfson, Pension Plans in Ontario: A Statistical Overview, in Research Studies, Volume 1.

**FIGURE 3.1**
Automatic Inflation Protection in Ontario, 1985
**(Proportions of all pension plan members)**




SOURCE: Table 3.1

members who have no automatic indexing and some indexing. In the public sector, 43.8% have no automatic indexing; in the private sector, 94.7% have no automatic indexing. The operation of the Superannuation Adjustment Benefits Act (SABA) is described, as well as several private sector plans. Three of the latter escalate according to an excess earnings formula.

Many private sector plans traditionally have provided ad hoc increases. Surveys of these practices are presented, but these surveys are severely limited in reliability. The extent of ad hoc practices is unknown. It is clear that practices vary considerably among plans.

About 300,000 public sector members in Ontario are in plans that lack automatic indexing. Close to 140,000 of these are members of OMERS, where an internal policy uses an excess earnings formula for escalating pension benefits. Regular ad hoc increases are given by the Ontario Hydro Pension Plan, the Workers' Compensation Board Superannuation Fund, the Hospitals of Ontario Pension Plan, and the Colleges of Applied Arts and Technology Pension Plans.

Finally, this chapter surveys the practices in other countries. The important general finding is that indexing of employment pensions is a recognized practice in other countries. In the Federal Republic of Germany, France, and Sweden, employers are required to index benefits. In the United Kingdom, employers who have opted out of the government plans are required to index that portion of the benefit which is

equivalent to the government pension to a maximum of 3 per cent.

**Chapter 4: Recent Studies**

Twelve studies are examined. These studies have supported alternative formulas and alternative treatment of retroactivity. These alternatives form the basis for the Friedland analyses. They include excess earnings, full CPI indexation with a deductible, partial indexation, and partial indexation with a deductible. This chapter notes that difficulties arose in reaching a single solution acceptable to all provincial governments and the federal government and that this lack of agreement has been a major cause of delay in legislating indexation.

**Chapter 5: Alternative Inflation Protection Formulas**

The alternative formulas presented in Chapter 4 are analyzed in Chapter 5, with a division into two categories: those linked to the CPI and those based on excess earnings. A variety of modifications are also analyzed, including caps on the annual adjustments, minimum floors to prevent negative adjustments, and different mandated formulas for different income levels.

Full inflation protection geared to 100% of CPI adjustments provides certainty of purchasing power to pensioners, but it shifts all the uncertainty onto the employers. One way the employer can minimize this uncertainty is to invest the pension funds in Treasury Bills, but this would reduce pension fund earnings. Faced with the costs and risks of full inflation protection, many employers would terminate defined benefit

plans. Some would shift to a defined contribution or group RRSP arrangement, but these plans create uncertainty for employees since the rate of return can vary significantly, and since the annuity purchased at retirement depends on the interest rate at that time.

Indexation at a certain percentage of the CPI leaves considerable uncertainty with the employee. One cannot predict the rate of decline of purchasing power. With, say, 60% of CPI, indexation may still leave a substantial decline of purchasing power with high inflation rates. It is important to note that OAS and CPP/QPP are fully indexed, and so a 60% of CPI formula provides considerably more that 60% indexation of the total pension.

Full inflation protection less a deductible, say (100% of CPI)-2½% removes all employee uncertainty about the purchasing power over time of the employment pension. The rate of decline in purchasing power over time can be predicted with certainty. However, for the employer there is considerable uncertainty about cost, and so these is considerable risk.

Partial inflation protection subject to a deductible, say (75% of CPI) - 1%, can provide greater retiree certainty than partial inflation protection while being less costly than full inflation protection. This formula is a compromise between the retirees' needs for certainty about purchasing power and the employer's needs for certainty about costs.

Three excess earnings formulas are analyzed. From the perspective of pensioners, these do not track inflation closely. Rather the adjustments are based upon market rates of return. Furthermore, the real rate of return on assets tends to decline whenever the rate of inflation rises unexpectedly. Hence the pension adjustments may be lowest when they are most needed. Nevertheless, these formulas do provide employers with considerable certainty in regard to costs.

The CAPSA recommendation for an excess earnings formula involved linkage to the bond market. The annual adjustment would be equal to the average interest rate over the last five years on long-term Canada bonds minus 3.5 per cent.

A second approach would be to link the formula to the yield on Treasury Bills, say this yield minus 3.5%. This tracks inflation more closely than does the CAPSA formula, though still imperfectly.

A third approach would be to link the formula to the fund yield less a stated percentage. This formula has the added disadvantage that adjustments would not be uniform across plans, but would depend on each plan's rate of return. Retirees would face this additional uncertainty. Annual variability within each plan would also be considerable. Nevertheless, the employer bears no risk since the formula depends solely on fund earnings.

In order to constrain the employer's risk that cost might climb to unexpectedly high levels, any formula chosen could include a cap on the maximum adjustment in any one year. A cap could be placed directly on the adjustment itself, or it could be linked to a specified portfolio. In a year when actual inflation exceeds this cap, the excess could be "banked". This combination of a cap and rollover has been implemented in a number of plans.

Some people believe that individuals with high incomes do not need inflation protection. From this perspective, legal standards need apply only up to a maximum level, specified in terms of income or pension benefit. However, it is not clear that this is a feasible administratively. Furthermore, this would not solve the redistribution problem caused by inflation. Even high income individuals may deserve to recapture the losses they experience when inflation reduces the purchasing power of a defined benefit and also reduces the employer's real cost of providing that benefit.

**Chapter 6: Alternative Inflation Indexes and the Needs of the Elderly**

This chapter examines alternative inflation indexes that could be used within an inflation protection formula. It is found that the official CPI measure of inflation has accurately reflected the changing costs of those goods and services purchased by the elderly. Other indexes are examined, including the National Accounts price index for consumer expenditure, a set of indexes for the cities of Toronto, Ottawa, and Thunder Bay, and a specially constructed price index for the elderly

population of Ontario. There is a strong case for using the all-Canada CPI.

The possibility is also considered of using a wage index. This would generally provide higher adjustments, since these would include gains from economic progress plus the impact of inflation. Should pensioners share in the gains from economic progress? This question is political or ethical, not solely economic. Full price indexing would maintain absolute purchasing power; full wage indexing would maintain relative purchasing power, compared with the average Ontario employee.

This chapter also considers whether the needs of the retired diminish with the aging process. If people need less as they age, then full inflation protection may not be necessary. Evidence is not found that would justify acceptance of declining real value for pensions. The only qualification to this statement is that people over 75 may, on average, spend less per capita than those under 75. It is important to note, however, that circumstances vary greatly among the elderly, particularly health status, and so needs vary greatly. Consequently, the justification for less than full inflation protection cannot lie in the supposed declining needs of the elderly.

**Chapter 7: Funding, Accounting, and Tax Considerations**

Actuaries and the Pension Commission of Ontario seek to ensure that adequate funds exist to pay for all pension commitments. To avoid situations where pensions cannot be paid, they chose conservative

or pessimistic estimates for the variables that are included in their calculations. They do not use average estimates or estimates that they consider most likely to occur. Consequently, as time passes, actual outcomes may often be more favourable that the projections, resulting in the development of surpluses. The following list indicates the variables for which estimates must be made:

**(a) Economic Assumptions**

(i) investment return

(ii) salary increases

(iii) development of government plans

(iv) post-retirement pension adjustments

**(b) Decremental Assumptions**

(i) incidence of normal, early and deferred retirement

(ii) disability and disability recovery

(iii) voluntary and involuntary termination

(iv) mortality before and after retirement or disability

**(c) Other Assumptions**

(i) family composition

(ii) marriage: marital status at termination, death, retirement; age differences between spouses; remarriage and divorce rates.

(iii) the level of administration expenses

(iv) election of optional forms of benefit

(v) number of hours worked by hourly-paid employees

(vi) the current compensation base upon which the salary increases are to apply

(vii) future new entrants to the plan

The PCO examines the assumptions underlying each fund, and it has veto power over these. If the PCO believes the assumptions are too optimistic and that, consequently, the fund should be increased, then the PCO can require that the assumptions be changed and that the contribution rates be increased.

In recent years, many plans have experienced a return on their assets substantially in excess of the projected assumptions. Hence surpluses have developed, together with the opportunity to take "contribution holidays". This means that today may be a good time for many plans to cope with the additional costs of inflation protection.

The accounting profession has recently instituted new guidelines for the assumptions to be used in computing plan assets and liabilities for the purposes of corporate financial statements. Presented in a revised Handbook, Section 3460, these guidelines require the use of "best estimates" or "most likely outcomes". In view of this, many corporate financial statements over the next few years will show larger surpluses than the traditional actuarial computations based on conservative or pessimistic assumptions. The cost computations for the Friedland Report present both the funding costs based on common actuarial assumptions and also the expensing costs based on probable accounting assumptions.

The procedures to be used in reporting and funding the costs of inflation protection are open to debate. At present, Section 8 of the Regulations, PBA 1987, permits "pay-as-you-go" procedures with no pre-

funding of these costs. Yet with this approach the risk to employees is severe. The company may suddenly encounter the combination of high inflation protection costs, low returns on pension fund assets, and poor corporate financial performance. The plan may simply be unable to provide the promised inflation protection. In view of this, it is most probable that the legislature will eliminate Section 8 of the Regulations. At that point, the procedures for reporting and funding any unfunded liabilities created by inflation protection could be based on alternative amortization time periods: perhaps 5 years, 15 years, or 25 years. If inflation protection is prospective only, then there may be no unfunded liabilities. But any retroactivity will create substantial unfunded liabilities, in which case this amortization question will be important. Many companies have granted retroactive ad hoc improvements regularly; the formal promise of such improvements will immediately create substantial unfunded liabilities.

It should be noted tnat with an excess earnings formula, the plan's assets can be used as the benchmark portfolio, such that all excess earnings above the assumed or projected rate of return will be given the the employees as inflation protection adjustments. With this approach, there is no need to pre-fund inflation protection. However, the employees than bear all the risk connected with the rate of return on the fund assets and with the actual rate of inflation.

For the private sector, the tax regulations are also significant. Anticipated increases in the deductible pension contribution limits will

make RRSPs more attractive than they have been in the past. Consequently, many plans will likely shift from defined benefits to RRSPs.

## Chapter 8: Cost Analyses

The cost analyses are in regard to defined benefit plans only. For defined contribution plans and RRSPs, one can purchase an escalating annuity from a life insurance company. With defined contribution plans and RRSPs, the employee carries all the risk connected with both inflation protection and the return to assets. Hence with these, there is no need to pre-fund inflation protection and to be concerned with the costs that must be met in the pre-funding.

It is important to note that if the government issued indexed bonds, then defined benefit contribution plans and RRSPs might be able to purchase escalated annuities at a more favourable price. In addition, it is important to note that defined benefit plans may become defined contribution plans or RRSPs under certain circumstances, at which point the employer no longer is concerned with pre-funding inflation protection for the relevant employees. This occurs if an employee terminates and requests the cash payment of the commuted value of the pension. In the computation of the commuted value, a cost complication involves the manner in which a present value is placed on any promised inflation protection. The assumptions used by the actuary in computing the commuted values are of key concern. The Friedland Report fails to address these assumptions and the procedures for computing commuted

values. This is a weakness of the Report. It is likely that many employees will choose to switch out of defined benefit plans and so these procedures will be become increasingly important.

The cost analyses are of three separate types:

Stage I: The long-run costs of inflation protection are estimated using traditional methods for a number of representative model plans.

Stage II: The first-year operating costs of inflation protection for 22 real plans are estimated from both funding and expensing perspectives.

Stage III: The operating cost profile of inflation protection in changing economic conditions is estimated for three of the Stage II plans over 20 years.

While the detailed analyses of Volume 3 provide a large number of insights that can help in understanding the cost impacts of inflation protection, the following general observations seem to be most relevant for the recommendations of the Task Force, and these are presented in Chapter 8.

(1) Three CPI-linked formulas that have received public consideration result in similar costs and benefits if annual inflation rates remain about 5 to 6 per cent:

* 60% of CPI
* (75% of CPI) - 1%
* (100% of CPI) - 2½%.

This finding is important if the government wishes to offer a choice of formulas in its legislation. An excess earnings formula based on the fund rate minus 3.5% is somewhat more generous to the employee

over the long term than are these three formulas, yet, as noted in Chapter 5, one may regard greater long-run generosity as an appropriate compensation for the greater risk that the employee will experience extreme outcomes.

(2) As can be seen from Volume 3 of the Research Studies, both the long-run costs of pensions and the costs of inflation protection as percentages of payroll usually decline as inflation protection rise. This is due partly to the fact that payrolls generally rise by more than the rate of inflation. Furthermore, for flat benefit and career average plans, as inflation projections rise, the level of pension benefits usually falls in real terms.

(3) For many plans, providing retroactivity in inflation protection effectively doubles or even triples the cost that would result from only prospective inflation protection. Hence, the decision on retroactivity is extremely important for costs. If inflation protection is prospective only, applying solely to benefits accruing after the date of legislation, costs will be much lower than if inflation protection is both prospective and retroactive, that is, applies to all pension benefits for both actives, retirees, and deferreds. It should be noted that retroactivity is an exceedingly complex subject and an entire chapter has been devoted to the various aspects of it.

(4) A most important determinant of the costs of retroactive inflation protection is the demographic composition of the plan members. At one extreme, a newly formed corporation with young employees and no retirees or deferreds may find that retroactive inflation protection could result in negligible costs. At the other extreme, a long-established corporation with older employees and many retirees and deferreds may find that retroactive inflation protection could result in huge costs.

(5) The timing of cost impacts will differ considerably between the traditional funding calculations and the expensing calculations required under the CICA guidelines, and between these on the one hand and the long-run costs on the other hand. Moreover, the degree and direction of these differences will vary considerably among plans. That is, the estimates of cost impacts must be considered from three perspectives: short-run funding, short-run expensing, and long-run costs. One's judgement about the cost of inflation protection will be affected by the relative weights one gives to these perspectives.

(6) The costs of inflation protection differ substantially among plans. This is true for both prospective and retroactive inflation protection and for each formula. These costs differences among plans are generally much more extreme for retroactive than for prospective inflation protection. For some plans, the current costs of retroactivity may be only one-half that of prospective inflation protection, while for others it may be three times as much. For example, Stage II analysis of first-year maximum additional funding costs showed that in plan 4 only 1.1 per cent of payroll would be needed for 100% of inflation protection with retroactivity, whereas in plan 17 it would take 4.5 per cent of payroll to get a modest 60% of inflation protection that is prospective only.

A number of factors can underlie these wide differences in cost impacts. As emphasized in point (4) above, demographics can vary substantially among plans. As discussed in Chapter 7, and as emphasized in point (5) above, the rules for funding and the rules for expensing affect different plans differently. The extent and regularity of previous ad hoc improvements offset the size of the additional costs imposed by mandatory inflation protection, and these have differed significantly among plans. Furthermore, differences in the level of pension benefits also affect the cost of inflation protection for those benefits. This means that the more generous a plan has been the greater its exposure to cost increases

as a result of mandatory inflation protection.

These differences in costs among plans must be considered in deciding upon the terms and conditions of mandatory inflation protection. If there are to be legislated minimum standards which individual plan sponsors may exceed in many cases, an important question concerns the weight to be given in setting those standards to those plans where even minimum standards will impose very large costs. Such plans might compel the selection of lower legislated standards than would be preferred if all plans were affected to the same degree.

(7) The results from Stage III calculations indicate that pension plan experiences differ greatly over time. From 1967 to 1986 the annual CPI increases ranged from 4 per cent to 12 per cent and the real return to a portfolio of 50 per cent bonds/50 per cent equity ranged from -23 per cent to +20 per cent. Even though a plan might be able to afford a certain inflation protection formula over the long term, there will probably still be times when that formula will add greatly to plan costs. This will be especially true for a salary-related plan if inflation is high when fund earnings are low. Once again, this means that legislated standards may have to be lower than one would choose if one were only considering the long-term impact. It also suggests putting a cap on the annual inflation adjustment so as to moderate the impact in unfortunate times. Furthermore, some may believe that provision for exemptions must be part of mandatory inflation protection in order that employers who cannot readily cope with exceptionally high cost increases can appeal for modifications and/or delays in meeting the legislated standards. This point lends weight to the argument that government should assist the inflation protection process by issuing indexed bonds, which would maintain a constant real return on fund assets even in difficult times.

(8) After calculating the cost of a certain inflation protection formula, it is difficult to judge whether that cost is unacceptably high. Judgements in this regard will vary among individuals and may vary over time. Would a cost for inflation protection of 10 per cent of payroll be unacceptably high? Would 2 per cent be? There is no simple criterion on which to judge these costs. Furthermore, the answer will probably differ between firms. For a firm with much capital and relatively few employees, 10 per cent of payroll may represent a very small percentage of total costs. Yet for a firm that is labour-intensive, 10 per cent of payroll may represent close to 10 per cent of total cost. As noted in point (5) above, for some firms the funding cost may be of greatest concern, while other firms may focus on accounting and expensing costs. Consequently, the decision to reject a certain formula on the basis of costs and to advocate a less generous formula is a decision about which honest judgements will differ. The same is true of the decision on retroactivity.

In view of the importance of Stage III, Table 8.4 is reproduced here:

## Table 8.4

### ANNUAL COST OF PARTIAL INFLATION PROTECTION (STAGE III)

Percentage of payroll, (75% of CPI) -1%

| Year | CPI | Fund Real Return | Flat Benefit | | Career Average | | Final Average | |
|---|---|---|---|---|---|---|---|---|
| | | | Funding | Expensing | Funding | Expensing | Funding | Expensing |
| 1967 | 4.20 | 4.65 | 2.05 | 2.50 | 0.68 | 1.24 | 2.12 | 2.17 |
| 1968 | 4.03 | 6.68 | 1.80 | 2.20 | 0.67 | 1.25 | 2.44 | 2.21 |
| 1969 | 4.65 | -4.98 | 1.50 | 2.00 | 0.64 | 1.20 | 2.30 | 2.18 |
| 1970 | 1.48 | 7.61 | 1.70 | 2.30 | 0.72 | 1.28 | 2.56 | 3.15 |
| 1971 | 4.87 | 4.68 | 2.10 | 2.30 | 0.50 | 1.16 | 3.49 | 2.72 |
| 1972 | 5.10 | 8.70 | 2.90 | 2.00 | 0.57 | 1.14 | 5.03 | 3.25 |
| 1973 | 9.27 | -7.58 | 4.30 | 2.20 | 0.58 | 1.13 | 2.74 | 3.35 |
| 1974 | 12.32 | -23.26 | 4.40 | 2.90 | 1.02 | 1.47 | 4.15 | 4.27 |
| 1975 | 9.53 | 1.02 | 5.60 | 3.40 | 1.82 | 1.88 | 12.33 | 6.85 |
| 1976 | 5.91 | 8.59 | 7.00 | 4.00 | 2.25 | 1.88 | 14.59 | 8.19 |
| 1977 | 9.46 | -1.02 | 6.50 | 4.30 | 2.18 | 1.69 | 12.30 | 7.82 |
| 1978 | 8.36 | 6.59 | 6.40 | 3.80 | 2.45 | 1.72 | 14.28 | 7.63 |
| 1979 | 9.80 | 10.27 | 7.50 | 4.30 | 2.56 | 1.78 | 13.11 | 6.54 |
| 1980 | 11.19 | 4.41 | 6.00 | 4.10 | 2.02 | 1.82 | 7.32 | 4.97 |
| 1981 | 12.10 | -16.71 | 4.90 | 3.50 | 1.75 | 1.79 | 4.53 | 4.91 |
| 1982 | 9.26 | 13.73 | 7.70 | 5.50 | 2.57 | 2.33 | 9.58 | 8.52 |
| 1983 | 4.55 | 17.21 | 6.70 | 5.60 | 2.42 | 2.14 | 8.85 | 7.79 |
| 1984 | 3.76 | 2.50 | 4.70 | 3.80 | 1.74 | 1.62 | 5.55 | 5.30 |
| 1985 | 4.35 | 19.95 | 4.40 | 3.90 | 1.56 | 1.67 | 3.20 | 4.43 |
| 1986 | 4.17 | 8.71 | 1.20 | 2.60 | 0.36 | 1.25 | -3.26 | 0.19 |
| **Summary Statistics** | | | | | | | | |
| Max. | 12.32 | 19.95 | 7.70 | 5.60 | 2.57 | 2.33 | 14.59 | 8.52 |
| Min. | 1.48 | -23.26 | 1.20 | 2.00 | 0.36 | 1.13 | -3.26 | 0.19 |
| Mean | 6.92 | 3.59 | 4.47 | 3.36 | 1.45 | 1.57 | 6.36 | 4.82 |
| Percentage increase in variability over no inflation protection | | | 42 | 44 | 27 | 38 | 44 | 45 |

NOTE: These three plans also appear in Stage II. The flat benefit is plan 2; the career average is plan 8; and the final average is plan 17.

SOURCE: Research Studies, Volume 3

## Chapter 9: Financial Instruments and Capital Markets

This chapter addresses two subjects: the desire of some plan trustees to purchase index-linked securities in order to reduce their plan's risk or vulnerability when their plan liabilities are index-linked; and the desire of some plan trustees to alter their portfolio mix of equities and debt as another response to the requirement that plan liabilities be index-linked.

The British government has successfully issued indexed bonds and, in Canada, index-linked mortgages have recently been issued. Small employers, in particular, and perhaps life insurance companies may wish to purchase such assets to match, to some degree, their index-linked liabilities.

Keith Ambachtsheer conducted a survey for the Task Force, asking plan managers whether mandatory inflation protection of pensions would alter their portfolio mix. About 75% indicated that they would not alter their asset mix in response to the legislated requirement for inflation protection. Among the other 25%, some would shift towards more equities in hope of raising investment returns to cope with higher pension costs, while an equal number would shift towards short-term bonds or Treasury Bills in order to ensure that the rate of return would track the inflation rate. The Task Force concluded:

> ....that a moderate inflation protection formula will not have a significant impact on pension fund asset mix and hence on the capital market. However, a prolonged period of exceptionally high inflation, accompanied by low or even negative real returns on assets, would create funding

problems for many plans and could lead to capital market disruptions. A cap on the level of inflation protection would be very important in such situations. We have also noted that government issuance of index bonds would facilitate the provision of inflation protection.

## Chapter 10: Deferred Pensioners

"Deferreds" are individuals who have left an employer but who retain entitlement to a pension that they will not receive until they reach retirement age. If this settlement is not increased to track the inflation rate, then the deferred will lose purchasing power over all the pre-retirement years as well as post-retirement years. A key question, then, is whether mandatory inflation protection should cover these pension entitlements over the pre-retirement years.

Three recent Ontario pension reforms have improved the deferreds position. First, the maximum time period of plan membership required before the employer's pension contributions "vest" - or become owned by the employee - has been shortened to two years. Second, the terminating employee now has the right to transfer this entitlement into another plan: either an RRSP, or a life insurance company annuity, or the pension plan of another employer. Third, the employee's contributions to the plan plus interest on those contributions must not exceed 50% of the transfer value of the entitlement. Any amount by which the employee's contribution plus interest exceeds 50% must be refunded to the employee.

The addition of pre-retirement inflation protection to this set of reforms is considered by some to be unnecessary. Certainly, the existence of these other reforms reduces the need for pre-retirement

inflation protection; and the imposition of pre-retirement inflation protection would reduce the need for the other reforms.

Nevertheless, the deferreds who do leave their pension entitlement with the original employer are not assisted by the portability options, and the 50% rule may not provide enough benefit to offset future inflation. For these deferreds, inflation protection is still necessary.

The choice of formula for pre-retirement indexing is also a matter for disagreement. The active employees are likely to receive pre-retirement benefit improvements in excess of the inflation rate. The indexing of deferreds could be linked to the benefit improvements of actives. Any alternative formula could be proposed and debated.

Finally, the employer costs of administration may be very high if many terminated employees choose to leave their pension entitlements as deferred. A government register for deferreds could be helpful in keeping records of addresses and amounts owed. Furthermore, to ease administrative costs, perhaps employers should have the right to insist that small amounts of deferreds be removed from the plan.

**Chapter 11: <u>The Retired and Retroactivity</u>**

Prospective inflation protection means that, as of the date of legislation, benefits accruing as a result of future work will be increased after retirement in accordance with a formula. However, prospective inflation protection does nothing for the pension

entitlements that have been earned prior to the date of legislation. Current retirees would receive no inflation protection. Conceivably, the traditional ad hoc improvements might even be diminished to pay for the inflation protection being promised to active employees, leaving the currently retired worse off than before the legislation. Retroactive inflation protection is concerned with the adjustments to pension entitlements earned prior to the date of legislation. Retroactive inflation protection can be based on a wide variety of alternative provisions and alternative formulas.

Prospective inflation protection may be viewed as part of the total compensation package being negotiated for active workers. Consequently, the higher costs associated with it may be offset by lower demands in other parts of the compensation package. In this way, employers may be able to shift some or all of these costs onto active workers. Retroactive inflation protection is not likely to be viewed as part of the active employees' compensation package. Hence, these costs are likely to be borne entirely by the employer's shareholders.

It is important to note that the costs of retroactivity vary considerably from one firm to another. Particularly hard hit would be firms with an older work force and a large number of retirees. Furthermore, even if retroactivity were compulsory, some retirees would lose because their former employer may be out of business, or because their pension is a life insurance company annuity.

A variety of incentives could be provided in the legislation to encourage employers to provide retroactivity. A less onerous formula could be required if the employer offered retroactive as well as prospective inflation protection. Funding requirements could be relaxed. A cap could be placed on inflation protection if retroactivity is provided. Most significantly, employer access to surplus could be dependent upon provision of retroactivity.

If retroactivity is mandated, the formula and other provisions could be phased in over a number of years, as emphasized in this chapter:

> In determining the phase-in procedures, considerable scope exists for choice among a wide variety of combinations of the elements discussed above: the initial starting formula, the total transition period, the number and timing of adjustments to the formula, the age at which inflation protection begins, and the changes in the cap or the maximum annual inflation protection. Techniques therefore exist for easing some of the impact of retroactivity. The important question, however, is whether mandated retroactivity is desirable.

**Chapter 12: Special Situations**

This chapter examines the arguments for exempting certain kinds of pension plans from the inflation protection legislation. For several of these plans, the conflict between employer and employee over ownership of surplus is not present. The fact that surplus automatically is used to increase benefits provides an ad hoc inflation protection without the need for a legislated formula.

**(i) Money Purchase Plans**

In these plans, the contribution rates of employer and employee are

defined in the agreement. At retirement, the employee receives a pension annuity that depends upon the amount that has accumulated in the fund, on his or her behalf. To require inflation protection would be to require that the pension annuity begin at a lower amount initially and then escalate over time, rather than being a level payment annuity.

People appear in the past to have preferred a level payment annuity rather than an escalating annuity that begins at a lower amount. Consequently, some money purchase plans might be changed to group RRSPs if an indexed annuity were compulsory.

**(ii) RRSPs**

In view of their similarity to money purchase plans and the ease of conversion if the latter are indexed, any legislated requirements should apply to both types of plans. In accordance with this view, Ontario should consider broadening the Pension Benefit Act to include RRSPs under its requirements.

**(iii) Multi-Employer Pension Plans (MEPPS)**

In a MEPP, employer contributions are fixed by collective bargaining and are part of the labour contract. The trustees receive these contributions and provide their members with a defined benefit pension. The trustees provide ad hoc increases to these benefit levels when the fund returns exceed expectations, and these ad hoc increases can be seen as inflation protection. Furthermore, trustees have a legal fiduciary obligation to treat pensioners in a fair manner.

However, some would argue that pensioners need the certainty of a formula rather than reliance on ad hoc increases. Furthermore, in allocating surplus fund earnings, the trustees must choose between the interests of actives, retireds, and deferreds. Mandatory inflation protection would provide minimum guidelines for this division of surplus earnings.

**(iv) Union Plans**

Some argue that plans where unions represent the employees are subject to the collective bargaining process, and so the best interests of the employees are automatically advanced. However, as with MEPPs, the interests of deferreds and retireds may not be represented adequately.

**(v) Generous Plans**

Some argue that generous plans should be exempt. Otherwise, the employers already providing the best pensions will be hit the hardest. However, such exemptions would create a patchwork of various formulas and exemptions, impeding the enforcement process and eliminating uniformity. Furthermore, surpluses are not addressed if these plans are exempted.

**(vi) Maximum Limits**

Some argue that incomes in excess of a certain level do not need inflation protection. However, salary level alone may not be indicative of substantial pension benefits. Furthermore, the choice of the maximum limit is open to debate, particularly since inflation will alter its relative purchasing power. The uniformity of legislated requirements

would be eliminated. Job changes would also complicate this approach since each individual would have entitlement to a series of pension rights each with a different degree of inflation protection.

## Chapter 13: Surplus

In choosing assumptions for the calculation of plan liabilities and projected fund rates of return, actuaries have used pessimistic or conservative estimates. Actuaries have wanted to ensure the security of the plan, and so have built an actuarial cushion into their estimates. Over the past few years, actual real rates of return have generally been higher than these estimates; and the actual rates of inflation and wage increased have been lower than these estimates. Hence, many plans have experienced surpluses.

Another significant cause of surpluses has been the federal tax rule that a plan cannot provide a pension in excess of $60,000. This limits the projected pensions of employees. When the contribution rates have remained unaltered, this has created surpluses that would disappear if the $60,000 limit were removed.

Employers have used these surpluses in a variety of ways. Benefits have been upgraded in many plans. Ad hoc increases to those currently retired have frequently been made. Contributions to the plan have been reduced or suspended. Some employers have withdrawn surplus for their own use. Today, the Ontario Pension Benefits Act, 1987 limits the ability of an employer to withdraw surplus. However, considerable

controversy remains over the legal ownership of surplus. In particular, the Act clarifies ownership only of those surpluses developing after 1/1/1988; it does not solve the pre- 1/1/1988 surplus question. The Task Force summarized the legal issues as follows:

> As the various legal opinions contained in Volume 2 indicate, there is no concensus on the question of ownership of pension surpluses. Two conflicting streams of case law have emerged. The first stream....maintains that pension funds are trusts set up only as a result of a contract. Their role is to guarantee a defined benefit. Therefore, any surplus is the property of plan sponsors, and employees are entitled only to the explicit contractual right (the defined benefit) bargained for in the labour contract, unless the terms of a particular plan specifically allocate the ownership of any surplus funds to them. This view is the more prevalent view in English case law, and was the basis of the decision in the 1986 Gainers case. This view is supported by Professors Ralph Scane and Donovan Waters (see Volume 2).
>
> The second approach views pension funds as trust funds established for the benefit of employees. As such, the plan sponsor may not claim ownership of the plan fund or any surplus that arises from it. This view is sometimes buttressed by the argument that deferred employer contributions to pension funds are explicitly or at least implicitly bargained for in the labour contract as a part of employee wages and would have been paid directly to employees has they not been allocated to pay for pensions. Thus, any accumulated fund resulting from this contribution belongs to the employees, for whose benefit the monies were originally set aside. Professor Bernard and Raymond Koskie favour this approach.

**Chapter 14: Summary and Recommendations**

* A CPI-linked formula should be selected as the legislated minimum standard for inflation protection.

* The formula (75% of CPI) - 1% should be the legislated minimum standard.

* The maximum annual CPI increase to be recognized in the pension adjustments should be 10%, with the excess adjustment in years when the CPI increase is more than 10% being carried forward to years in which the CPI increase is less that 10%.

* Negative inflation should be taken into account to decrease subsequent adjustments.

* The adjustment should take place at least once a year.

* Legislation should permit alternative arrangements that offer actuarially better inflation protection than the recommended standard of (75% of CPI) - 1%.

* The Pension Commission of Ontario should develop regulations and guidelines to assist plan sponsors and their actuaries in determining what arrangements would be considered to offer actuarially better inflation protection than the standard of (75% of CPI) - 1%.

* Legislation should require that adjustments for inflation protection begin at the later of the age of retirement or age 55.

* The formula (75% of CPI) - 1% should apply to deferred pensioners as a minimum legislated standard.

* Legislation should permit alternative arrangements for deferred pensioners that offer actuarially better inflation protection than the recommended standard of (75% of CPI) - 1%.

* The 50% employer contribution rule should be retained during the deferment period unless the plan sponsor applies inflation protection retroactively to deferred pensioners.

* Deferred pensions less than the value of one-tenth of the Average Industrial Wage at the time of termination should be allowed to remain in the plan only with the sponsor's consent.

* Sponsors of money purchase plans should be required to offer indexed annuities to retiring employees as an option.

* The Ontario government should introduce the sale of indexed bonds.

* Employer-sponsored group RRSPs should be covered by the Ontario Pension Benefits Act (and should be required to offer indexed annuities as an option).

* Employer-sponsored RRSP group plans with under 15 members should be exempt from the Pension Benefits Act.

* The federal and provincial governments should give careful consideration to locking-in before and after retirement at least part of the sum accumulated in individual RRSPs.

* Inflation protection legislation should commence at the end of any current collective agreement for the applicable employees, at which point it should be made retroactive to the date of the implementation of the inflation protection legislation.

* Mandatory inflation protection should apply to multi-employer pension plans.

* Inflation protection legislation for multi-employer plans should commence two years after the date of implementation.

* Inflation protection should be required for future earned benefits only, but sponsors should be encouraged to grant increases to retireds. Therefore, the sponsor should be permitted to choose the following phase-in period applicable to retireds (including deferreds who have retired) and to the past credits of active workers:

  (75% of CPI) - 2½% for the first five years;

  (75% of CPI) - 2% for the next five years for future benefits and permanently for the retroactive component;

  (75% of CPI) - 1½% for the next five years for future benefits;

  (75% of CPI) - 1% thereafter for future benefits.

* Plan sponsors who choose to grant retroactive increases should be permitted to commence inflation protection at the age of 65, and they may apply a cap with a rollover when the CPI increase exceeds 8% (rather than 10%).

* A more liberal initial 25-year amortization period be permitted for sponsors who grant retroactive increases.

* A plan sponsor who funds adequate inflation protection for accrued credits for actives, retireds, and deferreds may withdraw and keep any surplus funds, unless the plan document prohibits withdrawal. This recommendation should apply to existing surplus funds as well as future surplus funds.

* Before surplus can be withdrawn under [the above recommendation], inflation protection should be provided retroactively and funded using the formula of (75% of CPI) - 2%.

* The foregoing recommendation would continue to permits the plan sponsor to make the short-term funding decisions, (in contrast to the withdrawal of funds), subject of course to the funding regulations under the Ontario Pension Benefits Act.

* Plans terminated after December 1, 1987, should not be entitled to withdraw surplus funds until adequate inflation protection ....has been provided.

* The GAINS program should not have payments reduced by the inflation protection component of employment pension plans.